



## MontGuide

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# Montana Medical Care Savings Accounts (MSAs)

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A Medical Care Savings Account (MSA) can provide a deduction from Montana state income tax. This MontGuide explains who is eligible, what expenses are allowed, and how to set up an MSA.

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### THE MONTANA MEDICAL CARE SAVINGS ACCOUNT

Act allows Montanans to save money for medical expenses and long-term health care and reduce state income taxes at the same time.

While the term "medical care savings account" implies a savings account, a checking account is also permitted. The account holder can designate an account as a "Montana medical care savings account" at a financial institution (bank, savings bank, savings and loan association, credit union, or mutual fund company.)

An MSA must be separate from other accounts and only the account holder can have access to the funds. Joint accounts for MSAs are not allowed. In other words, spouses must establish separate MSA accounts.

The money that is deposited in an MSA is not subject to Montana income taxation while in the account or if used for eligible medical expenses for the account holder or his or her dependents. If an account holder does not use money deposited in his or her MSA during the year deposited, it remains in the account and earns interest that is free from Montana taxation. The money in the MSA then can be used for eligible medical care expenses in future years.

An MSA is not like the federal medical care flexible spending account offered by some employers where you either "use it" or "lose it" or the Health Savings Account (HSA) that is deducted from federal adjusted gross income.

#### Who is eligible for an MSA?

All resident taxpayers are eligible to establish a Montana MSA even if they have another health care plan provided by their employer. An MSA could be considered as a health care risk management tool for Montanans regardless of their employment—ranching, farming, mining, state, county or city employee, educator or health care professional, for example.

#### What are the limits on contribution amounts?

The maximum amount that can be used to reduce Montana taxable income is limited to \$3,000 annually for each taxpayer. A person can also put less than \$3,000 in an MSA. As long as the money is left in the MSA (or withdrawn for eligible medical expenses), it is not subject to state income taxation. *The amount that is used to reduce income for state income tax purposes is the total deposited in the MSA during the tax year—not the amount withdrawn from it for eligible medical care expenses.* A similar reduction is not allowed in income for federal income tax purposes.

**Example 1:** Barbara, a county employee, established an MSA at a local bank and deposited \$3,000 in the account on Jan. 31, 2005. During the year, she had \$2,000 in eligible medical expenses. On

Barbara's Montana Individual Income Tax Return, her taxable income of \$29,000 is reduced by her \$3,000 MSA deposit, not the \$2,000 she withdrew for eligible medical expenses.

The remaining \$1,000 in the MSA will continue to earn interest and is available to be withdrawn for eligible medical expenses in future years. However, Barbara can not use the remaining \$1,000 as a reduction of income in 2006. Barbara's Montana adjusted gross income for the year is \$26,000 (\$29,000 - \$3,000 = \$26,000). Her Montana income tax will be computed based on \$26,000, less allowable deductions. However, Barbara's federal income tax will be computed based on her federal adjusted gross income of \$29,000, less any allowable deductions that she has such as real estate and property taxes.

**Example 2:** Donna and Jim, a married ranching couple, each established separate MSAs and deposited a total of \$6,000 (\$3,000 in Jim's and \$3,000 in Donna's).

Their combined income of \$46,000 is reduced by \$6,000 to \$40,000 (\$46,000 - \$6,000 = \$40,000). Their Montana income taxes will be computed based on \$40,000, less allowable deductions. However, Donna and Jim's federal income taxes will be computed on their federal adjusted gross income of \$46,000, less allowable deductions that they are eligible for such as their motor vehicle taxes and home mortgage interest.

#### How much will I save on state income taxes?

A Montana taxpayer's adjusted gross income is reduced by the amount annually contributed to the MSA account. The amount can be up to \$3,000 for single filers and up to \$6,000 total for the two MSAs for joint filers. As a result of a reduction in income, there is a reduction in the Montana income tax that is due. The amount of reduction in Montana income taxes depends on the account holder's tax bracket (see Table 1, next page).

To figure approximately how much your Montana income tax would be reduced, multiply the amount deposited in your MSA account by the tax rate for your taxable income listed in Table 1. Any money used in the reduction of income in one year cannot be deducted from income in a future year.

**Example 3:** Nina, a high school teacher, reduced her Montana taxable income of \$34,500 by the \$3,000 she deposited in her MSA at a local credit union. Because in 2005 she is in a 6.9% Montana income tax bracket (above \$13,900), her deposit reduced the amount of her Montana income tax due by approximately \$207 (\$3,000 x .069 = \$207). Nina can not use the \$3,000 she deposited in 2005 to reduce her Montana income taxes in 2006. To be eligible for a state income

**Table 1: Montana Tax Bracket Rates (approximate for 2005)\***

Over	But not over	Multiply by
\$ 0	\$ 2,300	1%
\$ 2,300	\$ 4,100	2%
\$ 4,100	\$ 6,200	3%
\$ 6,200	\$ 8,400	4%
\$ 8,400	\$10,800	5%
\$10,800	\$13,900	6%
\$13,900	and over	6.9%

Source: 2005 Montana Individual Income Tax

\*Tax tables change yearly. Use this table as an approximation. Do not use this table to compute your Montana tax liability. For the most recent rates, go to <http://www.mt.gov/revenue>.

reduction of \$3,000 for the 2006 tax year, she must deposit \$3,000 between Jan. 1 and Dec. 31, 2006.

**Example 4:** Rob and Sheila, owners of a downtown business, deposited \$3,000 each in an MSA at a local savings bank. The deposits lowered their Montana taxable income by \$6,000. They are in a 6.9% Montana state income tax bracket, which means their income is taxed at the rate of 6.9% (tax tables change yearly). Their MSA deposits saved them approximately \$414 in state taxes ( $\$6,000 \times .069 = \$414$ ).

Money in an MSA can earn interest just like money deposited in other savings, checking, and investment accounts at financial institutions. The rate of interest is determined by the financial institution where the MSA is established. Interest earned and investment gains on an MSA are not subject to Montana income tax if left in the account or if withdrawn for eligible medical expenses.

**Example 5:** Doug, a young farmer, contributed \$3,000 annually in his MSA for three years. He had no medical expenses that exceeded his health insurance allowances during those years. His MSA earned interest of \$45 in the first year, \$90 the second year and \$135 the third year. None of the interest income was subject to Montana income tax because Doug left the earnings in his MSA. The interest is subject to federal income taxation.

### How do I report my MSA?

The amount of an MSA deposit is entered as a reduction on the Montana Individual Income Tax Return. For example, on Form 2A, Schedule II, for the year 2005, the amount deposited between Jan. 1 and Dec. 31, 2005 is entered on line 18 (keep in mind that this line number could change from year to year).

The earnings on an MSA are reported on the financial institution's 1099 form that is sent to the account holder and to the Internal Revenue Service (IRS). Some financial institutions send a 1099 form for each MSA. Others may include the MSA interest and investment gains in a total with other interest and investment accounts. Closely examine the 1099 so you will deduct only the appropriate amount on the MSA contribution line on the Montana Individual Income Tax. Remember, the MSA interest earnings must be declared on the federal income tax return.

Eligible medical care expenses that are paid with MSA funds cannot be deducted elsewhere on the Montana income tax return.

A person's medical expenses cannot be deducted on the federal income tax return unless they exceed 7.5% of federal adjusted gross income.

**Example 6:** Ben and Bethany have an adjusted gross income of \$45,000. Any medical expenses they could deduct on their federal return must be above \$3,375 ( $\$45,000 \times 0.075 = \$3,375$ ). Because

their medical expenses are \$3,000, they are not allowed a deduction on their federal return. However, because Ben and Bethany established Montana MSAs with a \$3,000 deposit each, they are able to reduce their Montana taxable income by \$6,000 even though their withdrawal totaled \$3,000.

### What are eligible medical care expenses?

Money withdrawn from an MSA is not subject to Montana income tax if used for either of two basic purposes:

#### 1. Paying eligible medical care expenses of the account holder or his or her dependents.

The Montana Department of Revenue accepts eligible medical care expenses as defined under the Internal Revenue Code Section 213 (d). They are the same expenses that are allowed as itemized deductions for federal income tax purposes such as medical insurance premiums; prescribed drugs; insulin; medical, dental, and nursing care. Special items such as eyeglasses, crutches, or hearing aids; transportation for medical care; and certain lodging expenses may also be eligible medical care expenses.

If you are covered under Social Security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The payroll tax paid for Medicare A is not an eligible medical expense. If you are not covered under Social Security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation, the premiums paid for Medicare A are an eligible medical care expense.

Medicare B is supplemental medical insurance. Premiums paid for Medicare B are eligible medical care expenses for a Montana MSA.

Medicare D is a new voluntary drug coverage insurance. Premiums paid for Medicare D are eligible medical care expenses for a Montana MSA.

The deductible amount and co-payments that are not covered by other types of health insurance are treated as eligible medical expenses.

A complete listing of eligible medical care expenses for a Montana MSA is available in IRS Publication 502, "Medical and Dental Expenses." You may print out the list from the IRS web site at: <http://www.irs.gov>.

#### 2. Purchasing long-term care insurance or a long-term care annuity for the long-term care of the MSA account holder or his or her dependents.

The Montana Department of Revenue also accepts as eligible medical care expenses, the purchase of long-term care insurance for the account holder and his or her dependents.

### What expenses are not eligible?

Money held in an MSA may not be used to pay any medical expenses that are reimbursable under some other type of insurance coverage.

**Example 7:** Keri, a state employee, had \$2,945 in medical expenses with all but \$100 covered by her health insurance policy. She cannot withdraw \$2,945 from her MSA as eligible medical care expenses because that was the amount already reimbursed to Keri by her health insurance company. However, she can withdraw the \$100 deductible that she paid for medical expenses that were not covered by her health insurance policy.

Other types of reimbursable items that do not qualify as eligible medical care expenses under the Montana MSA law include: medical expenses payable under an automobile insurance policy; workers' compensation insurance policy or self-insured plan; Federal HSA payment or medical expenses covered under a health coverage policy, certificate, or contract.

### Who are eligible dependents?

Money in an MSA can be used to pay eligible medical care expenses not only for the account holder, but also the taxpayer's eligible dependents. Under the Montana MSA Act eligible dependents are defined as:

- the spouse of the account holder;

**Example 8:** Shirley, a city employee, was seriously ill with \$6,000 in non-covered medical expenses. She can use \$3,000 of her husband's MSA to pay her medical expenses as well as the \$3,000 from her MSA.

- a child of the account holder, if the child:
  - is less than 19 years of age, or
  - is less than 23 years of age and enrolled as a full-time student at an accredited college or university, or
  - is legally entitled to subsistence, education, medical care, or other care necessary for the health, guidance, or well-being of the child who is not otherwise emancipated, self-supporting, married, or a member of the armed forces of the U.S., or
  - is mentally or physically incapacitated to the extent that the child is not self sufficient.

Individuals who have legally adopted a child can also establish MSAs and use the funds to pay for eligible medical care expenses for that child.

### Who can administer my MSA?

Montana law provides that an MSA can be administered by the individual account holder (self-administered) or by a registered account administrator. Most Montana MSAs are self-administered. Regardless of the type of administration selected, the account holder in all circumstances is required to maintain documentation to verify that MSA funds are used exclusively for eligible medical expenses.

#### Self-Administered Account Holders

Montana law allows an individual to self-administer his or her MSA. The MSA may be established with a financial or other approved institution (e.g., banks, savings banks, savings and loan associations, credit unions, mutual fund companies, and so on).

A self-administered MSA must be kept separate from all other accounts. It must be maintained specifically for eligible medical expenses for the individual account holder or any eligible dependents.

A self-administered account holder must file a Medical Care Savings Account annual reporting form (available from the Department of Revenue) with his or her Montana income tax return. The form is available on-line at <http://www.mt.gov/revenue>. Click on: Downloadable forms>Individual Income Tax Forms> (year you desire, for example 2005), Form MSA, Medical Care Savings Accounts Annual Reporting Information.

**Fees.** Ask the institution if they have any type of maintenance or service fees for MSAs. For example, one financial institution charges a \$1 fee per withdrawal for each one in excess of six per month. Another institution does not charge a service fee if the account holder maintains a \$300 minimum balance. If the account holder drops below the \$300 minimum, there is a fee of \$2 during each month the balance is below the minimum. Some institutions provide free checking for MSAs for depositors age 50 and older. The maintenance fee is not subject to taxes or penalties.

#### Registered Account Administrators

Most account administrators charge a fee for their services. The types of registered administrators that are allowed under Montana law include: A state or federally chartered bank, savings and loan, credit union, or trust company; a qualified health care insurer; a licensed CPA; a licensed public accountant; an enrolled agent; a Montana-licensed attorney; a broker, insurance producer or investment advisor

regulated by the commissioner of insurance; or an employer, if the employer has a self-insured health plan under ERISA.

Registered account administrators must provide annual reports by Jan. 31 of each year to the Department of Revenue. Information to be reported includes: The taxpayer's name and address; social security number; contribution amounts; withdrawal amounts and dates; interest earned; penalties for any unqualified withdrawals; and year-end account balances.

All medical records and expenses are to be kept confidential by the account administrator unless written authorization to release the records is provided by the account holder.

### What type of withdrawals can be made without penalty?

The account holder, not the account administrator or financial institution, is responsible for documenting that a withdrawal from an MSA was made for eligible medical expenses.

Withdrawals from an MSA for any purpose other than eligible medical expenses are subject to a Department of Revenue 10% penalty on the amount withdrawn unless the withdrawals fall under one of the three exception rules:

1) An MSA account holder can withdraw MSA money on the last business day in December, even if the money is not used for eligible medical expenses. However, the amount withdrawn is included as ordinary income for Montana income computation tax purposes.

**Example 9:** Thomas, a rancher, established an MSA in March of 2005. He did not have any medical expenses during the year so the amount carried over to 2006. On the last business day of the year in 2006, he withdrew \$3,000 from his MSA to use for unexpected repairs on his combine. Thus, his Montana adjusted gross income for 2006 increased by the \$3,000 withdrawal. However, Thomas did not have to pay a 10% penalty because the amount was withdrawn on the last business day of the year.

2) A withdrawal upon the death of an account holder is not subject to the 10% penalty. The amount withdrawn, however, is added to the decedent's Montana income for the tax year in which the death occurred.

3) The direct transfer of funds from one MSA to another MSA with a different account administrator or a different financial institution is not considered a withdrawal and, therefore, is not subject to the 10% penalty. In a direct transfer, the funds in an MSA are transferred directly to a new account without the account holder receiving any funds.

**Penalties.** Self-administered account holders who make withdrawals from an MSA that were not used to pay qualifying medical expenses must complete Form MSA-P. In addition, the penalty must be reported on his or her Montana tax return for the appropriate year. For the tax year 2005, for example, the 10% penalty would be entered on the Montana Individual Income Tax Return on Form 2, line 65.

MSAs are provided to Montana residents for the purpose of paying eligible medical care expenses. Individuals who make false claims about eligible medical care expenses can be penalized.

### What happens to my MSA if I die?

If an account holder dies or becomes incapacitated, Montana law provides a legal procedure for distributing the money in the MSA. If the deceased person's MSA is with a registered account administrator, the account administrator is responsible for distributing the principal and accumulated interest in the account to the estate of the account holder or to a designated pay-on-death (POD) beneficiary. This action should be completed within 30 days of the financial entity being furnished proof of the death of the account holder.

If the MSA is self-administered, the MSA is a part of the estate of the deceased account holder. The personal representative who is appointed by the district court is responsible for notifying the financial entity of the death of the account holder.

If a POD beneficiary is designated on the MSA, the proceeds are distributed to that individual. If a POD beneficiary is not designated, the money in the MSA is distributed according to the account holder's written will or the Montana law of intestate succession if the person had no written will.

POD beneficiaries cannot transfer the inherited MSA into their MSAs.

**Example 10:** Rob named his wife as the POD on his Montana MSA. When he died his wife had to declare the balance of \$6,000 as income for Montana income tax computation purposes.

If an account holder becomes incapacitated, the funds cannot be withdrawn unless power of attorney is given to another individual or unless a conservatorship is granted to another individual.

A power of attorney is a written document in which a person gives another person legal authority to act on his or her behalf in financial transactions. (For more information on power of attorney request MontGuide MT199001 from your Extension office)

A conservatorship is a court-ordered protective relationship whereby an individual is appointed to manage another person's financial affairs after that person has become unable to do so. An attorney must file a petition with the district court and a judge decides if the person is legally competent.

#### What if I move from Montana?

If an MSA account holder moves from Montana with unused funds, those unused funds are considered nonqualified withdrawals must be declared as income on his or her final Montana Income Tax Return on Form 2A, Schedule I, line 8, 2005.

#### Planning Techniques

Montana taxpayers who are not sure if they will have eligible medical expenses during the year can wait until the last business day in December to open an MSA.

**Example 11:** Matt kept documentation of his medical expenses that were not covered by health insurance throughout the year and found they totaled \$2,225. On the morning of Dec. 31, the last business day of the year, he transferred \$2,225 from his regular savings account to establish an MSA. The next day, he withdrew \$2,225 from the MSA and placed the funds back into his regular savings account. Matt can reduce his Montana income by the \$2,225 he deposited into his MSA even though the money was in the account for less than 24 hours. With his tax return for the year he files the MSA annual reporting form with an entry of \$2,225. Had Matt withdrawn the money each

time he had an eligible medical expense he would have entered each transaction on the form.

#### Summary

- The Montana Medical Care Savings Account Act allows a Montana taxpayer to establish an MSA and contribute up to \$3,000 annually.
- If principal and earnings are withdrawn for payment of eligible medical care expenses or for long-term care of the account holder or a dependent, then the amounts are excluded from state income tax. However, the amount is subject to taxation at the federal level.
- Withdrawals from an MSA for any purpose other than eligible medical expenses are treated as ordinary income and taxed accordingly.
- Withdrawals are also subject to a 10% penalty unless the withdrawal falls under the exception rules listed previously.
- An MSA either can be managed by a registered account administrator or self-administered by the individual account holder.

#### Further Information

If you have questions or need additional information regarding Montana Medical Savings Accounts contact:

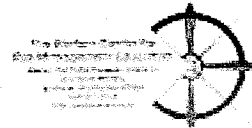
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